

DOCKET FILE COPY ORIGINAL

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of

Schools and Libraries Universal Service
Support Mechanism

)
)
)
)
)
)

CC Docket No. 02-6

**THIRD REPORT AND ORDER AND
SECOND FURTHER NOTICE OF PROPOSED RULEMAKING**

Adopted: December 17, 2003

Released: December 23, 2003

Comment Date: 30 days after publication in the Federal Register

Reply Comment Date: 60 days after publication in the Federal Register

By the Commission: Chairman Powell, Commissioners Abernathy, Copps, and Adelstein issuing
separate statements.

TABLE OF CONTENTS

	<u>Para.</u>
I. INTRODUCTION AND SUMMARY	1
II. PROGRAM OVERVIEW AND BACKGROUND.....	4
III. THIRD REPORT AND ORDER.....	9
A. Limits on Use of Internal Connections	9
1. Background	9
2. Discussion	11
B. Eligible Services.....	31
1. Background	31
2. Discussion	35
C. Carryover of Funds	50
1. Background	50
2. Discussion	52
IV. SECOND FURTHER NOTICE OF PROPOSED RULEMAKING.....	59
A. Discount Matrix	59
B. Competitive Bidding Process.....	63
C. Definition of Rural Area	67
D. Definition of Internet Access	70
E. Wide Area Networks.....	72
F. Recovery of Funds	78
G. Other Actions to Reduce Waste, Fraud, and Abuse.....	86
H. Miscellaneous	97
V. PROCEDURAL MATTERS	99

A. Paperwork Reduction Act Analysis	99
B. Final Regulatory Flexibility Analysis	100
C. Initial Paperwork Reduction Act of 1995 Analysis	120
D. Initial Regulatory Flexibility Analysis	121
E. Comment Filing Procedures	135
F. Further Information.....	144
VI. ORDERING CLAUSES	146

APPENDIX A -- FINAL RULES

APPENDIX B -- DISCOUNT MATRIX

APPENDIX C -- EXAMPLES OF TWICE-EVERY-FIVE-YEARS RULE

APPENDIX D -- PARTIES FILING COMMENTS AND REPLY COMMENTS

I. INTRODUCTION AND SUMMARY

1. In this Third Report and Order and Second Further Notice of Proposed Rulemaking, we address several matters related to the administration of the schools and libraries universal service mechanism (also known as the e-rate program). First, in the Third Report and Order, we adopt rules that will limit the ability of schools and libraries to engage in wasteful or fraudulent practices when obtaining internal connections. Specifically, we conclude that eligible entities should be precluded from upgrading or replacing internal connections on a yearly basis. Instead, our rules will permit a particular eligible entity to receive support for discounted internal connections services no more than twice in every five years. We will permit, however, entities to receive discounts on basic maintenance associated with internal connections on a yearly basis, but clarify our rules regarding permissible maintenance costs to ensure that such discounts are appropriately narrow. We also prohibit a school or library from transferring equipment purchased with universal service discounts, as part of eligible internal connections services, for a period of three years except in limited circumstances.¹ These rules will advance the goals of the schools and libraries program by making support for internal connections regularly available to a larger number of applicants and by discouraging waste, fraud, and abuse. We also adopt a rule creating a more formal process for updating annually the list of services eligible for support. In addition, we codify the Universal Service Administrative Company's (USAC or the Administrator) current practices for allocating costs of services between eligible and ineligible components consistent with Commission rules and requirements, codify a prohibition on the provision of free services to entities receiving discounts, and codify with one modification procedures for service substitutions. We also clarify existing requirements for eligibility of certain equipment and services. Finally, we adopt rules to implement our prior decision to carry forward unused funds from the schools and libraries mechanism for use in subsequent funding years. All rule changes and clarifications shall be implemented upon the effective date of this Order, unless specified otherwise.

¹ Although the schools and libraries support mechanism provides discount support for services, many supported services have component parts. In this Order, references to "equipment" will refer, for simplicity, to equipment components of eligible internal connections services.

2. In the Second Further Notice, we seek comment on several issues, including whether we should change (1) the discount matrix used to determine the level of discounts for which applicants are eligible, (2) the current competitive bidding process, (3) the definition of "rural area" used in the program, (4) the definition of Internet access, (5) current rules relating to wide area networks, and (6) current procedures for recovery of funds. We also seek comment on measures to limit waste, fraud, and abuse and improve the Commission's ability to enforce the rules governing the program. Finally, we seek additional comment on how to ensure the goals of section 254 continue to be met.

3. This order is one of a series of orders designed to simplify program administration, ensure equitable distribution of funds, and protect against waste, fraud, and abuse. In taking these additional steps today, we draw on information from a number of sources, including issues raised in a public forum held in May 2003 on ways to improve the schools and libraries support mechanism,² the Office of the Inspector General's semi-annual reports,³ beneficiary audit reports, and the recommendations of USAC's Waste, Fraud, and Abuse Task Force.⁴ We remain committed to making ongoing changes to ensure that this program continues to benefit school children and library patrons across America.

II. PROGRAM OVERVIEW AND BACKGROUND

4. Under the schools and libraries universal service support mechanism, eligible schools, libraries, and consortia that include eligible schools and libraries, may receive discounts for eligible telecommunications services, Internet access, and internal connections.⁵ Prior to applying for discounted services, an applicant must conduct a technology assessment and develop a technology plan to ensure that any services it purchases will be used effectively.⁶ The applicant then must submit to the Administrator a completed FCC Form 470, in which the applicant sets

² Forum on Improving Administration of the Schools and Libraries Universal Support Mechanism (May 8, 2003) (*E-Rate Public Forum*).

³ Semiannual Report to Congress, April 1-September 30, 2003, Office of the Inspector General, Federal Communications Commission, at 3-15; Semiannual Report to Congress, October 1, 2002-March 31, 2003, Office of the Inspector General, Federal Communications Commission, at 4-12; Semiannual Report to Congress, April 1-September 30, 2002, Office of the Inspector General, Federal Communications Commission, at 2-10 (filed October 31, 2002) (collectively, *Semi-Annual Reports of the Inspector General*).

⁴ See Task Force on the Prevention of Waste, Fraud, and Abuse, Universal Service Administration Company (filed November 26, 2003) (*Task Force Recommendation*).

⁵ 47 C.F.R. §§ 54.502, 54.503.

⁶ *Federal-State Joint Board on Universal Service*, CC Docket 96-45, Report and Order, 12 FCC Rcd 8776, 9077-78 paras 572-74 (1997) (*Universal Service Order*). A technology plan must meet five requirements: (1) clear goals and a realistic strategy for using telecommunications and information technology to improve education or library services; (2) a professional development strategy to ensure that staff know how to use these new technologies to improve education or library services; (3) an assessment of the telecommunication services, hardware, software, and other services that will be needed to improve education or library services; (4) a sufficient budget to acquire and support the non-discounted elements of the plan: the hardware, software, professional development, and other services that will be needed to implement the strategy; and (5) an evaluation process that enables the school or library to monitor progress toward the specified goals. See *id*

forth its technological needs and the services for which it seeks discounts.⁷ Once the school or library has complied with the Commission's competitive bidding requirements and entered into agreements for eligible services, it must file an FCC Form 471 application to notify the Administrator of the services that have been ordered, the service providers with whom the applicant has entered into an agreement, and an estimate of funds needed to cover the discounts to be given for eligible services.⁸

5. The Administrator reviews the FCC Forms 471 that it receives and issues funding commitment decisions indicating discounts that the applicant may receive in accordance with the Commission's rules. Subsequently, the applicant either: (1) pays the bill in full, and seeks reimbursement for discounts from the Administrator via the service or equipment provider, or (2) pays the non-discount portion of the service cost to the service provider, who, in turn, seeks reimbursement from the Administrator for the discounted amount.⁹

6. Under the Commission's rules, eligible schools and libraries may receive discounts ranging from 20 percent to 90 percent of the pre-discount price of eligible services, based on indicators of need.¹⁰ Schools and libraries in areas with higher percentages of students eligible for free or reduced-price lunch through the National School Lunch Program (or a federally approved alternative mechanism) qualify for higher discounts for eligible services than applicants with low levels of eligibility for such programs. Schools and libraries located in rural areas also generally receive greater discounts.¹¹

7. The Commission's priority rules provide that requests for telecommunications services and Internet access for all discount categories shall receive first priority for the available funding (Priority One services). The remaining funds are allocated to requests for support for internal connections (Priority Two services), beginning with the most economically disadvantaged schools and libraries, as determined by the schools and libraries discount matrix. Currently, the most disadvantaged schools and libraries are eligible for a 90 percent discount on eligible services, and thus must pay only 10 percent of the cost of the service. To the extent funds remain after discounts are awarded to entities eligible for a 90 percent discount, the rules provide that the Administrator shall continue to allocate funds for discounts to applicants at each descending single discount percentage. The Commission's rules also provide that if sufficient funds do not exist to grant all requests within a single discount percentage, the Administrator shall allocate the

⁷ 47 C.F.R. § 54.504(b)(1), (b)(3).

⁸ 47 C.F.R. § 54.504(c).

⁹ Schools and Libraries Universal Service, Billed Entity Applicant Reimbursement Form, OMB 3060-0856 (October 1998) (FCC Form 472 or BEAR Form); Schools and Libraries Universal Service, Service Provider Invoice Form, OMB 3060-0856 (October 2001) (FCC Form 474 or SPI Form).

¹⁰ See 47 C.F.R. § 54.505

¹¹ *Id.* See also Appendix B (discount matrix).

remaining support on a pro rata basis over that single discount percentage level.¹²

8. As the program approached its fifth year of operation, the Commission issued the *Schools and Libraries NPRM* to seek comment on ideas raised by both the applicant and service provider communities for improving the program.¹³ In particular, the Commission sought comment on ways to ensure that the program funds are utilized in an efficient, effective, and fair manner, while preventing waste, fraud, and abuse. On June 13, 2002, the Commission released the *Schools and Libraries Order*, which adopted a framework for the carryover of unused funds from the schools and libraries universal service support mechanism.¹⁴ On April 30, 2003, the Commission released the *Schools and Libraries Second Order and Further Notice*, which adopted a debarment rule and other measures to ensure that program funds are utilized in an efficient, effective and fair manner, and sought comment on additional matters, including the implementation of the carryover of unused funds to subsequent years.¹⁵

III. THIRD REPORT AND ORDER

A. Limits on Use of Internal Connections

1. Background

9. Because demand for discounts from the schools and libraries universal service support mechanism has exceeded the annual \$2.25 billion cap, in recent funding years only applicants eligible for the highest discount percentages have received discounts for internal connections.¹⁶ Thus, applicants in the highest discount percentages have been able to repeatedly apply for and receive discounts for Priority Two services, while applicants in the lower discount bands have not received any Priority Two discounts because the annual funding has been exhausted. Moreover, nothing in our current rules expressly preclude entities with 90 percent discounts from replacing, on a yearly or almost-yearly basis, equipment obtained with universal service discounts, and

¹² 47 C.F.R. § 54.507(g)(1)(i-iv); see also *Federal-State Joint Board on Universal Service*, CC Docket 96-45, Fifth Order on Reconsideration and Fourth Report and Order, 13 FCC Rcd 14915, 14938 para. 36 (1998) (*Fifth Order on Reconsideration*).

¹³ *Schools and Libraries Universal Service Support Mechanism*, CC Docket 02-6, Notice of Proposed Rulemaking, 17 FCC Rcd 1914 (2002) (*Schools and Libraries NPRM*).

¹⁴ See *Schools and Libraries Universal Service Support Mechanism*, CC Docket No. 02-6, Report and Order, 17 FCC Rcd 11521 (2002) (*Schools and Libraries Order*).

¹⁵ See *Schools and Libraries Universal Service Support Mechanism*, CC Docket No. 02-6, Second Report and Order and Further Notice of Proposed Rulemaking, 18 FCC Rcd 9202 (2003) (*Schools and Libraries Second Order or Schools and Libraries Further Notice*).

¹⁶ For example, USAC estimates that the demand for discounts for Funding Year 2003 of the schools and libraries program is \$4.718 billion. See Letter from George McDonald, Vice-President, Universal Service Administrative Company, Schools and Libraries Division, to William Maher, Chief of the Wireline Competition Bureau, Federal Communications Commission, April 3, 2003. Funding years are described by the year in which the funding period starts. For example, the funding period which begins on July 1, 2003 and ends on June 30, 2004, is called Funding Year 2003. The funding period which begins on July 1, 2004, and ends on June 30, 2005, is called Funding Year 2004.

transferring that equipment to other entities with lower discount percentages that otherwise would not receive funding for such equipment due to the exhaustion of the capped amount.¹⁷ The Act and our existing rules provide only that equipment purchased with universal service discounts “shall not be sold, resold, or transferred in consideration for money or any other thing of value.”¹⁸

10. With the goals of promoting equitable distribution of program funds and preventing waste, fraud, and abuse, the Commission sought comment in the *Schools and Libraries NPRM* on whether to revise these rules.¹⁹ Specifically, it sought comment on whether the program’s goals would be better achieved by requiring that schools and libraries make significant use of the discounted equipment that they receive, before seeking to substitute new discounted equipment. The Commission proposed two options. The first option would limit transfers of equipment for three years from the date of delivery and installation of equipment for internal connections other than cabling, and ten years in the case of cabling.²⁰ The second option would deny internal connections discounts to any entity that has already received discounts on internal connections within a specified period of years, regardless of the intended use of the new internal connections.²¹ Virtually all commenters that responded to these issues raised in the *Schools and Libraries NPRM* agreed that some form of restriction on the use of internal connections was appropriate, although parties had differing views on which measures would best carry out the Commission’s goals.²²

2. Discussion

11. In this Order, we adopt a rule limiting each eligible entity’s receipt of discounts on internal connections to twice every five funding years. We exempt basic maintenance services from this restriction. We also clarify the types of maintenance services that are eligible for discounts. In addition, we adopt a rule that limits an entity’s ability to transfer equipment purchased with universal service funds.

¹⁷ See 47 C.F.R. § 54.617.

¹⁸ 47 U.S.C. § 254(h)(3), 47 C.F.R. § 54.513.

¹⁹ *Schools and Libraries NPRM*, 17 FCC Rcd 1914. A list of the parties that filed comments and/or replies in response to the *Schools and Libraries NPRM* and the *Schools and Libraries Further Notice* is provided in Appendix D.

²⁰ *Schools and Libraries NPRM*, 17 FCC Rcd at 1930-31 para. 39.

²¹ *Id.* at 1931 para. 40.

²² Some commenters supported limiting equipment transfers. See, e.g., State of Alaska NPRM Comments at 8; American Library Association, BellSouth Corporation and SBC Communications NPRM Comments at 18; Colorado Department of Education NPRM Comments at 7; Council of the Great City Schools NPRM Comments at 4; Iowa Communications Network NPRM Comments at 2; Maine Public Utilities Commission NPRM Comments at 4; New York Board of Education NPRM Comments at 6; Seattle Public Library NPRM Comments at 2, TAMSCO Telecommunications Division NPRM Comments at 3. Other commenters supported restrictions on the receipt of internal connections discounts. See, e.g., Bakersfield Schools District NPRM Comments at 3; Central Susquehanna Intermediate Unit NPRM Comments at 3; City of Boston NPRM Comments at 8; Illinois State Board of Education NPRM Comments at 22; Quaker Valley School District NPRM Comments at 1; Siemens Enterprise Network NPRM Reply at 2; Spectrum Communications Cabling Services NPRM Comments at 3; York County Library System NPRM Comments at 10.

12. *Frequency of Discounts* We conclude that each eligible entity may receive commitments for discounts on Priority Two services, except as discussed below, no more than twice every five funding years.²³ The practical effect of this rule will be to permit applicants to receive funding once every three years for internal connections, as supported by the record,²⁴ but will allow applicants to obtain internal connections in two consecutive years as part of a staged implementation of internal connections.²⁵ In order to give applicants sufficient planning time, we conclude that this rule will become effective beginning with support received in Funding Year 2005. Commitments for Priority Two services received in years prior to Funding Year 2005 will not be considered in determining an applicant's eligibility to receive support for Priority Two services.

13. For the purpose of determining whether an applicant is eligible to receive a funding commitment for Priority Two services under this rule, the five-year period begins in any year, starting with Funding Year 2005, in which the entity receives discounted Priority Two services. The rule is applicable to discounts for services that are site-specific to the entity and for services that are shared by the entity with other entities. Thus, if an entity receives support only for shared services in a particular funding year, that funding will be counted as one of the two years out of five that it may receive support.²⁶ The restriction does not apply to consortium members who do not actually receive Priority Two funding when other members of the consortium receive discounts in specific funding periods.

14. We find that, by limiting the frequency in which applicants may receive Priority Two discounts, funds will be made available to more eligible schools and libraries on a regular basis.

²³ For the purpose of implementing this rule, an entity is an individual eligible school or library as defined in our rules. See 47 C.F.R. § 54.501(b), (c). We note that each individual school or library is currently given an "entity number" to facilitate processing of the FCC Form 471.

²⁴ Several commenters suggest limiting discounts on internal connections to every two or three years. See, e.g., Central Susquehanna Intermediate Unit NPRM Comments at 3; Integrity Networking Systems, Inc. NPRM Comments at 3; Marian High School NPRM Comments at 1; Michigan Department of Information Technology NPRM Comments at 15; North Carolina Department of Cultural Resources NPRM Comments at 1; Pennsylvania Department of Education NPRM Comments at 7; Siemens Enterprise Networks NPRM Reply at 2. See also *E-rate Public Forum*, American Library Association Statement at 3 and Central Susquehanna Intermediate Statement at 4.

²⁵ For example, under this new rule, a school or library could receive support for internal connections in Funding Year 2005, Funding Year 2008, and Funding Year 2011. Alternately, a school that receives support for Priority Two services in Funding Years 2005 and 2006 will not be eligible to receive support for Priority Two services until Funding Year 2010. In another example, if a school receives discounts in Funding Year 2006 and then in Funding Year 2010, it would be eligible to receive Priority Two discounts again in Funding Year 2011. Appendix C provides, for illustrative purposes, examples of what would be permitted under this rule.

²⁶ Applying the twice-every-five-years restriction to all entities receiving shared services in this manner is necessary to prevent avoidance of this rule by applicants that might seek discounts more frequently than permitted by nominally identifying services as shared when they are intended primarily to serve a single entity. We recognize that attributing shared services in this way will result in the need for additional planning by entities that receive support for shared services. However, we find that such planning is consistent with the Commission's existing policies regarding plans for using technology. Moreover, such applicants are free to seek support for non-shared services in that same year, or the other year in the five-year cycle in which they will be permitted to receive support for Priority Two services.

Specifically, we find that the twice-every-five-years rule we adopt balances this goal with the need to ensure that the most disadvantaged schools and libraries are able to maintain functioning internal connections networks. Permitting applicants to receive support more often than twice every five years would not make funds available to significantly more eligible schools and libraries, while limiting applicants to support less frequently than twice every five years could prevent applicants from updating their internal connections as necessary.

15. We are not persuaded by those commenters that assert that the most disadvantaged applicants will suffer from a policy restricting receipt of internal connections discounts.²⁷ The Commission remains committed to ensuring that discounts continue to flow to schools and libraries that are economically disadvantaged. Indeed, program rules continue to provide greater discounts for the most economically disadvantaged schools and libraries. We recognize, however, that many applicants below the very highest discount levels are also economically disadvantaged and also unable to acquire internal connections without universal service support. We also recognize that demand for universal service discounts will likely continue to exceed the annual funding cap. Thus, we agree with commenters that without revising our existing policies, some economically disadvantaged applicants will continue to be denied Priority Two funding.²⁸ We find that the twice-every-five-years restriction is appropriate and necessary to make advanced technologies more accessible to all schools and libraries. We further find that the twice-every-five-years policy will increase the mechanism's funding reach to a greater number of economically disadvantaged schools and libraries.

16. It is important to note that even with this revised policy on the funding of internal connections, funding commitments will continue to be made in accordance with the annual funding cap. Thus, it is conceivable that an applicant may be eligible to apply for discounts on Priority Two services and still be denied funding because demand for discounts exceeds available funding. In this instance, we encourage applicants to reapply for discounts during the following funding year. We further note that it is the receipt of support for Priority Two services, rather than the application for support, that counts toward the limitation that an entity may receive in only two out of five years.

17. Furthermore, we conclude that, by precluding a particular entity from receiving support for Priority Two discounts every year, our modified rule strengthens incentives for applicants to fully use equipment purchased with universal service funds. Our current rules permit applicants in the highest discount bands to upgrade their equipment on a yearly basis, even when existing equipment continues to have a useful life.²⁹ By limiting each eligible entity's ability to receive

²⁷ See, e.g., Council of the Great City Schools NPRM Comments at 4; Memphis City Schools NPRM Comments at 2, Montana Independent Telecommunications Systems NPRM Comments at 7 ("denying internal connections within a specified period of years regardless of the intended use...creates a barrier for the most disadvantaged schools..."), New York Public Library NPRM Comments at 2.

²⁸ See, e.g., Bakersfield School District NPRM Comments at 3, Colorado Department of Education NPRM Comments at 8, Marian High School NPRM Comments at 1.

²⁹ A school or library is expected to use equipment purchased with universal service discounts for the specified purpose for a reasonable period of time. Although we decline to adopt useful life criteria for such equipment, see (continued ...)

support for internal connections, recipients will have greater incentive not to waste program resources by replacing or upgrading equipment on an annual basis.

18. A few commenters maintain that limiting funding of internal connections will disrupt applicants' planning and budgets.³⁰ We recognize that our modified rule will limit applicant flexibility to some extent, particularly for those applicants that wish to make modest infrastructure investments on a yearly basis. But, we conclude that the benefits of the rule--namely, making support available to more applicants on a regular basis and preventing wasteful and abusive practices--outweigh the potential impact on such applicants. We find that the twice-every-five-years restriction provides sufficient flexibility for applicants to make efficient use of Priority Two funding, and thus is reasonable. In particular, we recognize that for a variety of different reasons, an applicant may not be able to make efficient use of program discounts in a single year. For example, an applicant's annual resources may require the applicant to extend its costs over a period of years. Our modified rule allows an applicant to seek internal connections discounts in two consecutive years, thus, enabling an entity to spread its costs over two funding years.³¹ We conclude that providing applicants the flexibility to implement internal connections over two consecutive years is sufficient to accommodate the differing planning and budgetary needs of most applicants. We expect applicants to assume the responsibility of adequately planning and budgeting to make the most effective use of discounts available to them.

19. USAC also suggests that in an effort to counter funding limitations, some applicants may request more funding than they will be able to use in a given funding year.³² We emphasize that existing program rules require applicants to examine their technology needs and budgetary resources before making funding requests to ensure that applicants make effective use of any discounted services that they receive.³³ Failure to have an approved technology plan is a violation

(Continued from previous page)

infra para. 30, we address this issue by adopting a general prohibition on the transfer of equipment for a period of three years after purchase. See *infra* paras. 25-29.

³⁰ See, e.g., Excalibur Internet Corporation NPRM Comments at 5; Funds for Learning NPRM Comments at 13; Information Technology Industry Council NPRM Reply at 3; Los Angeles Unified School District NPRM Comments at 7; National Education Association, International Society for Technology in Education and the Consortia for School Networking NPRM Comments at 19; TAMSCO Telecommunications Division NPRM Comments at 3.

³¹ We therefore reject commenters' suggestion that the Commission grant internal connection requests only once every other year. See, e.g., American Library Association NPRM Comments at 42 (ban equipment purchases for the same location two years in a row); Council of Chief State School Officers NPRM Comments at 45 (limit to once every other year); Council of the Great City Schools NPRM Comments at 4; Illinois State Board of Education NPRM Comments at 22; Marion High School NPRM Comments at 2; Spectrum Communications Cabling Services NPRM Reply at 2.

³² See USAC NPRM Comments at 24.

³³ On the FCC Form 471, among other things, applicants must certify that they have secured access to "all of the resources, including computers, training, software, maintenance, and electrical connections necessary to make effective use of the services purchased as well as to pay the discounted charges for eligible services." See FCC Form 471, OMB No. 3060-0806 (December 2002). These certifications are consistent with the requirements set forth in the *Universal Service Order*. See *Universal Service Order*, 12 FCC Rcd 8776, 9079 para. 577 (applicants for schools and libraries discounts would be required to certify in their requests for services that "all of the necessary funding in (continued...)

of our current rules.³⁴ We expect funding requests to be based on an applicant's technology plan, not based on a scheme to maximize funding. A funding request that is not reasonably based on a technology plan does not constitute a *bona fide* request for services.³⁵ Further, the Administrator's review and enforcement of the necessary resources certification must and will continue to serve as a safeguard against unreasonable funding requests.³⁶

20. *Maintenance Costs* We agree with commenters that maintenance costs should be exempt from the twice-every-five-years restriction.³⁷ The *Universal Service Order* provides that support for internal connections includes "basic maintenance."³⁸ Maintenance costs associated with internal connections services are currently eligible for discounts as a Priority Two service.³⁹ Proper maintenance of internal connections products ensures that equipment functions properly, thereby limiting uneconomical replacement of equipment. We therefore continue to allow applicants to apply for discounts for maintenance of equipment each funding year.

21. We instruct USAC to revise Block 5 of the FCC Form 471 to include a separate category of service for maintenance requests, with this form change to take effect for Funding Year 2005.⁴⁰ Maintenance requests will continue to be funded as Priority Two funding.⁴¹ However, maintenance requests will be considered for funding separately from other requests for Priority Two funding and, therefore, will not be subject to the twice-every-five years funding rule we adopt in this Order.⁴² The revision of the FCC Form 471 will allow efficient review of the Priority Two funding requests.

(Continued from previous page)

the current funding year has been budgeted and will have been approved to pay for the 'non-discount' portion of requested connections and services as well as any necessary hardware, software, and to undertake the necessary staff training required in time to use the services effectively")

³⁴ 47 C.F.R. § 54.504(b)(2)(vii).

³⁵ 47 U.S.C. § 254(h)(1)(B)

³⁶ Particularly, where an applicant provides an inaccurate or inadequate necessary resources certification in connection with its funding request, the Administrator will deny such funding requests.

³⁷ See, e.g., Council of Chief State School Officers NPRM Comments at 4, Illinois State Board of Education NPRM Comments at 22, Siemens Enterprise Networks NPRM Reply at 2.

³⁸ *Universal Service Order*, 12 FCC Rcd at 9021 para. 460.

³⁹ See SLD's Eligible Service Lists on USAC's website, <http://www.sld.universalservice.org/data/pdf/Eligible%20Services%20List%2010-18-02.pdf>.

⁴⁰ USAC develops the forms used in the schools and libraries mechanism under Commission oversight. The Commission obtains OMB approval for those forms.

⁴¹ We therefore reject commenters' suggestion that the Commission revise the priority for maintenance. See, e.g., Integrity Networking Systems, Inc. NPRM Comments at 3; Tel/Logic, Inc. NPRM Comments at 18 (internal connections maintenance would remain a Priority Two service, but create a priority three category for new internal connections equipment); but see Spectrum Communications Cabling Services NPRM Reply at 6 (establishing a preference for maintenance is unnecessary).

⁴² Based on the data entered in Block 5, USAC will create a database/record of an entity's receipt of Priority Two funding, and where appropriate, deny an entity's request for discounts.

22. In response to allegations of waste, fraud, and abuse, we prospectively clarify the services eligible for Priority Two support as basic maintenance costs for internal connections. Although the *Universal Service Order* allows support for those internal connections services that are "necessary to transport information all the way to individual classrooms" and public areas of a library, and specifically authorizes support for "basic maintenance services" that are "necessary to the operation of the internal connections network,"⁴³ our rules do not expressly specify the types of maintenance costs that are eligible for support. In light of our concerns about allegations of waste, fraud, and abuse in this area and our changes above, we conclude that we should provide further clarity on what maintenance services are "necessary" under the terms of the *Universal Service Order*, and thus eligible for support and exempt from the twice-every-five-years rule.

23. Basic maintenance services are "necessary" if, but for the maintenance at issue, the connection would not function and serve its intended purpose with the degree of reliability ordinarily provided in the marketplace to entities receiving such services without e-rate discounts. Basic maintenance services do not include services that maintain equipment that is not supported or that enhance the utility of equipment beyond the transport of information, or diagnostic services in excess of those necessary to maintain the equipment's ability to transport information. For example, basic maintenance will include repair and upkeep of previously purchased eligible hardware, wire and cable maintenance, and basic technical support, including configuration changes. On-site technical support is not necessary to the operation of the internal connection network when off-site technical support can provide basic maintenance on an as-needed basis. Services such as 24-hour network monitoring and management also do not constitute basic maintenance. Such services are therefore ineligible for discounts under the schools and libraries universal service mechanism.

24. We also provide greater clarity as to how USAC should address requests for discounts on technical support for internal connections. When confronted with products or services that contain both eligible and ineligible functions, USAC, in the past, has utilized cost allocation to determine what portion of the product price may receive discounts.⁴⁴ We generally endorse this practice as a reasonable means of addressing mixed use products and services. At the same time, however, we are concerned that it is administratively difficult and burdensome to derive reasonable cost allocations for the eligible portions of services provided under a technical support contract. In a rapidly-changing marketplace, with vendors supplying complex packages of services, it simply is not administratively feasible to determine what portion of a technical support contract is directed to basic maintenance. Therefore, we hereby clarify prospectively that technical support, including on-site Help Desks, is not eligible under our rules if it provides any ineligible features or functions. A Help Desk system typically goes beyond the level of support authorized by the Commission in the *Universal Service Order*, which stated that "[s]upport should be available to fund discounts on such items as routers, hubs, network file services, and wireless LANs and their installation and basic maintenance...."⁴⁵ There is no language in the *Universal*

⁴³ *Universal Service Order*, 12 FCC Rcd at 9021-22 para. 460.

⁴⁴ See www.sl.universalservice.org/reference/costallocationguide.asp.

⁴⁵ *Universal Service Order*, 12 FCC Rcd at 9021 para. 460 (emphasis added).

Service Order that contemplates the provision of discounts for the comprehensive level of support typically provided by a Help Desk. On the contrary, the *Universal Service Order* indicates that support will be provided for a product or service "only if it is necessary to transport information all the way to individual classrooms. That is, if the service is an essential element in the transmission of information within the school or library"⁴⁶ We conclude that if a technical support contract provides more than basic maintenance, it shall be ineligible for discounts under our modified rules. We instruct USAC to review and fund requests for discounts on maintenance services in accordance with this clarification, as of the effective date of this Order.⁴⁷

25. *Equipment Transfers.* We also find it appropriate to amend our rules expressly to prohibit, except as provided below, the transfer of equipment purchased with discounts from the schools and libraries universal service support mechanism. The Act prohibits the sale or transfer of equipment purchased with discounts from the universal service program in consideration of money or anything else of value.⁴⁸ Here, in order to promote the goal of preventing waste, fraud, and abuse, we extend that prohibition to all transfers, without regard to whether money or anything of value has been received in return for a period of three years after purchase.⁴⁹

26. Recipients of support are expected to use all equipment purchased with universal service discounts at the particular location, for the specified purpose for a reasonable period of time. Purchasing equipment with universal service discounts and then replacing or upgrading that equipment annually or almost annually is unnecessary and not economically rational.⁵⁰

⁴⁶ *Id.* at 9021 para. 459.

⁴⁷ To the extent this clarification impacts existing contracts, we shall permit parties 90 days from the effective date of this Order to renegotiate those contracts, or to provide the Administrator with an itemized breakout of the components of the contract, clearly identifying the portion of the contract price to be allocated to basic maintenance. We will permit parties to utilize cost allocation for signed contracts in existence as of the effective date of this Order. The burden is on the applicant to justify what portion of a contract price should be allocated to basic maintenance services.

⁴⁸ 47 U.S.C. § 254(h)(3).

⁴⁹ This action is not intended to prevent schools or libraries from trading-in equipment to a service provider for other equipment with similar functionalities. We note, however, that under the twice-every-five-years rule we adopt today, an applicant may face limitations on its ability to finance trade-ins using e-rate funding. The school or library may not use the credit for the trade-in to pay for its non-discounted portion of the services it receives in return.

⁵⁰ Colorado Department of Education NPRM Comments at 8 (applicants that receive funding for internal connections year after year pose a risk of abuse of the program); Delaware Center for Educational Technology NPRM Comments at 3 (the idea that a school district could upgrade the poorest schools in the district yearly and transfer the 'old' equipment to other schools is definitely abuse of the system); E-Rate Elite NPRM Comments at 15 (applicants transferring equipment in violation of program rules are circumventing the funding process, abusing the program, and preventing students with a greater need from receiving much needed assistance); Excaliber Internet Corporation NPRM Comments at 5 (continual transfers of equipment are wasteful of program funds); Florida Public Service Commission at 5 (it is necessary for the FCC to establish rules governing when equipment can be transferred; inadequate incentives exist to prevent such wasteful or fraudulent behavior); Iowa Communications Network NPRM Comments at 1 (transfer of equipment yearly to ineligible users seems to counter the goals of the program); Montana Independent Telecommunication System NPRM Comments at 6 (applicants (continued. . .)

Unnecessary replacement of equipment suggests that entities are not fully utilizing the equipment purchased with universal service discounts. We agree with commenters that such practices deprive other eligible entities of the full benefits of the schools and libraries universal services program.⁵¹ Moreover, the practice of purchasing equipment with universal service funds, then transferring that equipment to other schools and libraries with lower discount rates would undermine the intent of the Commission's priority rules, and is therefore prohibited. We find, however, that it would be wasteful to prevent recipients from transferring equipment that, after a reasonable period of time, has been replaced or upgraded. We therefore permit recipients freely to transfer equipment to other eligible entities three years or more after the purchase of such equipment.⁵² Consistent with the Act, however, such transfers must not be in consideration of money or anything else of value.

27. We agree also with commenters that argue that applicants may have legitimate reasons to transfer internal connections equipment due to the closing of a school or other eligible facilities.⁵³ For example, due to a natural disaster, a school district may conclude that its needs are best served by temporarily or permanently closing a particular school and transferring its students, as well as any valuable equipment purchased with supported discounts, to other locations. Similarly, a school district may choose to close, remodel, or consolidate a particular school to meet changing demographic needs or fiscal realities, and thereby transfer the students and useable school property to a nearby school. Likewise, a county or municipality may choose to close a library branch for financial reasons. Under these circumstances, we find that it would be economically rational and consistent with the goals of the schools and libraries program for the support recipient to transfer any equipment it has purchased with universal service discounts to another eligible location where the equipment may be used effectively.⁵⁴ We therefore conclude that a recipient may transfer equipment purchased with universal service discounts to other eligible entities if the particular location where the equipment was originally installed is permanently or temporarily closed. In these limited circumstances, we note that it is not necessary for the transferring and receiving entities to have comparable discount levels, as long as each is eligible under the schools and libraries program.

28. In the event that a recipient is permanently or temporarily closed and equipment is

(Continued from previous page)

that transfer equipment obtained with universal service discounts to other schools and libraries that may not be eligible for such equipment adversely affect funding availability for all applicants).

⁵¹ See, e.g., E-rate Elite NPRM Comments at 15, Excaliber Internet Corporation NPRM Comments at 5, Iowa Communications Network NPRM Comments at 1, Montana Independent Telecommunication System NPRM Comments at 6-7, Software & Information Industry Association at 4; see also *Task Force Recommendation* at 6 (recommending prohibition on transfers within service life of equipment).

⁵² The conclusion that three years is a reasonable period for a recipient to retain equipment purchased with internal connections discounts is consistent with our conclusion, above, that an applicant should be limited to internal connections discounts in only two out of every five years. In effect, the twice-in-five-years rule will permit an applicant to seek discounts for internal connections every three years. See *supra* para. 12.

⁵³ See, e.g., Florida Public Service Commission NPRM Comments at 4-5.

⁵⁴ Consistent with the Act, such transfers may not be in consideration of money or anything of value. 47 U.S.C. § 254(h)(3)

transferred, the transferring entity must notify the Administrator of the transfer, and both the transferring and receiving entities must maintain detailed records documenting the transfer and the reason for the transfer for a period of five years. We instruct the Administrator to verify compliance with this requirement as part of its beneficiary audit reviews. In order to enable the Administrator to verify compliance with this transfer prohibition, we require all recipients of internal connections support to maintain asset and inventory records for a period of five years sufficient to verify the actual location of such equipment.⁵⁵

29. This rule change shall be implemented upon the effective date of this Order. To facilitate enforcement of this rule, we will amend the FCC Form 471 for Funding Year 2005 to include a reasonable use certification.⁵⁶ In order to receive discounts, applicants must certify that they will use all equipment purchased with universal service discounts at the particular location for the specified purpose. Applicants will thereafter be held accountable for their compliance with the reasonable use certification.

30. We decline to institute useful life criteria for equipment purchased with universal service funds.⁵⁷ Useful life criteria could provide a more equitable distribution of Priority Two funding and ensure that more applicants receive the full benefit of the program by ensuring that applicants did not replace equipment components of internal connections services more frequently than necessary. We believe, however, that measures adopted above, including the restriction of transfers and our revised policy governing the funding of Priority Two equipment, will provide similar results in achieving these goals.⁵⁸ We also conclude that developing and enforcing useful life criteria would add a significant degree of complexity to the program, which would result in increased administrative costs and burden for both recipients and USAC.

B. Eligible Services

1. Background

31. Since the initial implementation of the schools and libraries support mechanism, USAC has developed various procedures and guidelines, consistent with the Commission's rules and requirements, for applicants to ensure that funding is provided only for eligible services. These policies include guidelines for allocating costs between eligible and ineligible services, a prohibition on the provision of free services, the eligible services list maintained on USAC's website, and procedures for service substitutions.

32. In the *Universal Service Order*, the Commission concluded that, when a school or library signs a contract for both eligible services and ineligible services, the contract must break

⁵⁵ This recordkeeping requirement will become effective upon receiving any approval required from the Office of Management and Budget (OMB) under the Paperwork Reduction Act.

⁵⁶ FCC Form 471 already is in use for Funding Year 2004, so it is not feasible to amend the form to include this certification for Funding Year 2004.

⁵⁷ See, e.g., *Task Force Recommendation* at 6; see also Tel/Logic Inc. NPRM Comments at 14.

⁵⁸ See *supra* paras 12-19, 25-28

out the price of eligible services separately.⁵⁹ This rule cannot be easily applied, however, in those circumstances when a single product or service contains both eligible and ineligible elements. For example, a particular service may be eligible or ineligible depending on how it is used, or internal connections may provide functionality that is ineligible for support. For that reason, the Administrator developed guidelines to aid service providers and applicants in determining how costs of a single service or product should be allocated between eligible and ineligible functions.⁶⁰ These guidelines distinguish between products and services that have a significant element that is ineligible for support, and products and services with ineligible components that are merely ancillary to the eligible components. Cost allocation may be used for products and services with mixed eligibility, including significant ineligible components, only when a clear delineation can be made between the eligible and ineligible component parts. There must be some tangible basis for this delineation, even if the basis is not strictly based on cost.⁶¹ The price for the eligible portion must represent the most cost-effective means of receiving the eligible services. For products or services that contain an ineligible functionality on an ancillary basis, the Administrator does not require the allocation of any portion of the cost to the ineligible use. However, the price for the service or product must be the most cost-effective means of receiving the eligible component of the service, without regard to the value of the ineligible component.

33. USAC advises the public, consistent with Commission rules and requirements, that applicants and service providers are prohibited from using the schools and libraries support mechanism to subsidize the procurement of ineligible or unrequested products and services.⁶² Applicants and services providers are further cautioned that any such promotions or discounts must be accounted for in the e-rate funding request to reveal the true cost the applicant would incur vis-à-vis the service provider proposed contract.⁶³ Price reduction, free goods or services, and trade-in values are among the promotions that require accounting and proper allocation to capture the true cost of service.⁶⁴

34. Currently, USAC updates on a yearly basis, and posts to its website, a list of services eligible for funding under the categories of telecommunications service, Internet access, and internal connections.⁶⁵ USAC updates the list, in consultation with the Wireline Competition Bureau, to reflect any changes in rules that have occurred over the last year and to address issues

⁵⁹ *Universal Service Order*, 12 FCC Rcd at 9022 para. 462.

⁶⁰ See <http://www.sl.universalservice.org/reference/costallocationguide.asp>.

⁶¹ For example, the cost allocation may be based on the added cost or added market value of the ineligible functions. In circumstances where there is purely economic basis for separating the costs, the cost allocation may be based on data demonstrating how the product's use will be divided between eligible and ineligible services.

⁶² See <http://www.sl.universalservice.org/reference/freeservices.asp>.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ See <http://www.sl.universalservice.org/reference/eligible.asp>.

that arise in the application review process. In the *Schools and Libraries NPRM*, the Commission invited parties to submit proposals for rule changes that would improve the operation of the eligibility determination process in terms of efficiency, predictability, flexibility, and administrative cost.⁶⁶ Since the issuance of the *Schools and Libraries NPRM*, a number of parties have urged the Commission to create a more transparent process for updating the eligible services list.⁶⁷

2. Discussion

35. Although the current cost allocation approach used by the Administrator reasonably implements the Commission's rules and requirement regarding eligible and ineligible services, we conclude that administration of the schools and libraries support mechanism would benefit from an explicit rule regarding the cost allocation for services with mixed eligibility. We also conclude that the eligibility process would be improved by adopting a rule for the yearly updating of the eligible services list. Additionally, we codify rules prohibiting the provision of "free" services to recipient schools and libraries by service providers that also provide supported services to those schools and libraries and codify procedures for applicants to modify funding requests that have been granted but not yet funded. Finally, we provide additional guidance on the provision of discounts on services that include the lease of on-premises equipment.

36. Cost Allocation We specifically amend our rules to make clear how applicants and service providers should allocate costs of a service or product that, although generally eligible for universal service support, contains both eligible and ineligible components. In the *Universal Service Order*, the Commission concluded that, when a school or library signs a contract for both eligible and ineligible services, the contract must break out the price of eligible services separately from ineligible services.⁶⁸ Since that time, the marketplace has seen an evolution of products and services that contain both eligible and ineligible features but which are not commercially available on an unbundled basis. Thus, the issue has evolved from merely separately listing eligible services and products from ineligible services and products to one of determining what components or features of an otherwise eligible service or product may be ineligible when the service or product is not commercially available on an unbundled basis. Consistent with the Commission's directive to separate these costs, the Administrator has generally required schools, libraries, or the service provider to separate the costs of an ineligible component from what generally would be an eligible service or product.⁶⁹ As explained above, the Administrator has provided reasonable guidance, consistent with Commission rules and requirements, to schools,

⁶⁶ *Schools and Libraries NPRM*, 17 FCC Rcd at 1921 para. 14.

⁶⁷ See Alaska NPRM Comments at 2; Central Susquehanna NPRM Comments at 2; Iowa DOE Comments at 3, 7, Greg Weisiger NPRM Comments at 9; ITI NPRM Reply at 2; NASTD NPRM Reply at 1; *E-rate Public Forum*, Funds for Learning Statement at 5.

⁶⁸ *Universal Service Order*, 12 FCC Rcd at 9022 para. 462.

⁶⁹ See <http://www.sl.universalservice.org/reference/eligible.asp>. In addition, in those instances where a school requests support for a service or product with mixed use components, the Administrator has only provided support for the eligible component. *Id.*

libraries, and service providers in determining the allocation approach.⁷⁰

37. As part of our efforts to improve the operation of the eligibility determination process,⁷¹ we explicitly amend our rules to include cost allocation rules for services and products that contain mixed eligible and ineligible components, features, or functions to provide greater clarity in this area. Under these rules, if a product or service contains ineligible components, costs should be allocated to the extent that a clear delineation can be made between the eligible and ineligible components. The clear delineation must have a tangible basis and the price for the eligible portion must be the most cost-effective means of receiving the eligible service. If the ineligible functionality is ancillary, the costs need not be allocated to the ineligible functionality. An ineligible functionality may be considered "ancillary" if (1) a price for the ineligible component that is separate and independent from the price of the eligible components cannot be determined, and (2) the specific package remains the most cost-effective means of receiving the eligible services, without regard to the value of the ineligible functionality.

38. These cost allocation rules address the widespread availability of products and services with mixed eligibility and are fully consistent with the overriding requirement that support be provided for eligible services, while preventing support for ineligible services. By providing service providers and applicants a means of allocating costs between eligible and ineligible components, features or functions of what would otherwise be an eligible service, the cost allocation method increases the variety of service options available to schools and libraries, improving each school or library's ability to purchase the most useful and cost-effective service possible. Without this cost allocation approach, applicants may fail to pursue the purchase of certain advanced telecommunications and information services, contrary to the intent of section 254. Our E-rate rules should not drive the development of communications services and technologies, but rather should permit the marketplace to flourish and innovate in ways that meet consumer needs and facilitate access to these innovations. Schools and libraries should continue to allocate eligible and ineligible costs in their contracts with service providers. In the interests of ensuring that support be provided only for eligible services, the Administrator also should continue to employ the use of the cost allocation method when necessary.⁷²

39. The Commission recently addressed those circumstances where an applicant erroneously identifies certain costs as eligible for support by adopting the 30 percent rule. Specifically, we concluded in the *Second Report and Order* that where less than 30 percent of a

⁷⁰ See *supra* para 32.

⁷¹ *Schools and Libraries NPRM*, 17 FCC Rcd at 1921 para. 14.

⁷² Although there is language in the *Universal Service Order* that suggests that schools and libraries should not receive universal service support for contracts that provide only one price for a bundle of mixed eligibility services, the Commission's intent was to ensure adequate cost allocation between eligible and ineligible services and to avoid imposing an excessive burden on the Administrator. See *Universal Service Order*, 12 FCC Rcd at 9022-23 para. 462. As a practical matter, the application process evolved in such a manner that this concern could be adequately addressed by the Administrator. Thus, in those instances where the Administrator has been presented with mixed eligibility services during the application process, the Administrator has been able to resolve the cost allocation with the school or library and service provider in a reasonable way, and avoid committing universal service support to ineligible services.

request for support is ineligible, the Administrator is permitted to grant support, reduced by the amount of ineligible services.⁷³ We clarify that the Administrator may rely on the cost allocation methods we adopt today in applying the 30 percent rule and performing any resulting adjustments.

40. Eligible Services List. We now adopt a more formalized process for updating the eligible services list, beginning with Funding Year 2005. Under the new rule, USAC will be required to submit by June 30 of each year a draft of its updated eligible services list for the following funding year.⁷⁴ The Commission will issue a Public Notice seeking comment on USAC's proposed eligible services list. At least sixty days prior to the opening of the window for the following funding year, the Commission will then issue a public notice attaching the final eligible services list for the upcoming funding year. The Commission anticipates that this public notice will be released on or before September 15 of each year. This process will provide greater transparency to the development of the eligible services list. The yearly updated list will interpret what may be funded under current rules, and will represent a safe harbor that all applicants can rely on in preparing their applications for the coming funding year. It will provide interested parties, both recipients and service providers, an opportunity to bring to the Commission's attention areas of ambiguity in the application of current rules in a rapidly changing marketplace. Currently, the only way an applicant can determine whether a particular service or product is eligible under our current rules is to seek funding for that service or product, and then seek review of the Administrator's decision to deny discounts. The rule we adopt today will simplify program administration and facilitate the ability of both vendors and applicants to determine what services are eligible for discounts.

41. Prohibition of "Free" Services. We also take this opportunity to clarify and amend our rules to codify a prohibition on the provision of free services to an eligible entity by a service provider that is also providing discounted services to the entity.⁷⁵ The Commission requires that an entity must pay the entire undiscounted portion of the cost of any services it receives through the schools and libraries program.⁷⁶ For the purpose of this program, the provision of unrelated free services by the service provider to the entity constitutes a rebate of the undiscounted portion of the costs, a violation of the Commission's rules. Codifying this existing restriction will clarify the obligations of schools and libraries that receive discounted services under the schools and libraries program and improve the ability of the Commission to take appropriate enforcement action.

⁷³ *Schools and Libraries Second Order*, 18 FCC Rcd at 9215-16 paras. 40-41. We found that this rule improves operation of the schools and libraries program by permitting the Administrator to process efficiently requests for support for services that inadvertently include some ineligible components.

⁷⁴ For instance, on June 30, 2004, USAC would submit its draft eligible services list for Funding Year 2005.

⁷⁵ <http://www.sl.universalservice.org/reference/freeservices.asp> (Free Service Advisory notes that requests that do not account for free services will result in a denial and may result in criminal penalties).

⁷⁶ *Universal Service Order*, 12 FCC Rcd at 9035-36 para. 493 (citing *Federal-State Joint Board on Universal Service*, CC Docket 96-45, Recommended Decision, 12 FCC Rcd 87, 367 para. 549 (1996)); see also <http://www.sl.universalservice.org/reference/obligation.asp>.

42. *Service Substitution.* Again, as part of our efforts to improve the operation of the schools and libraries support mechanism, we also formally adopt and codify the Administrator's current procedures relating to requests for service or equipment changes.⁷⁷ These procedures provide flexibility to applicants where it has become necessary to make a minor modification to their original funding request.⁷⁸ We find that the Administrator's service substitution procedures are consistent with the Commission's goal of affording schools and libraries maximum flexibility to choose the offering that meets their needs most effectively and efficiently.⁷⁹ We conclude that codifying these existing procedures in our rules will facilitate USAC's administration of the schools and libraries support mechanism. In codifying USAC's procedures in our rules, we make one modification, however. USAC's current procedures permit a service substitution only if the substitution does not result in an increase in the pre-discount price of the eligible service. We will permit applicants to substitute an eligible service with a higher pre-discount price, but will provide support based on the lower, original price, rather than the higher price for the substituted service.⁸⁰ We agree with commenters that this will further maximize flexibility for schools and libraries to meet their needs effectively and efficiently, without additional cost to the E-rate program.⁸¹

43. Accordingly, we amend our rules to specify that service change requests will be granted for a substitute service or product where (1) that service or product has the same functionality;⁸² (2) the substitution does not violate any contract provisions or state or local procurement laws; (3) the substitution does not result in an increase in the percentage of ineligible services or functions, but (4) support shall be provided based on the lesser of the pre-discount price of the original service or the substitute service. In order to ensure the integrity of the competitive bidding process, we require the applicant's request for a service change to include a certification that the requested change in service is within the scope of the controlling Form 470, including any associated Requests for Proposal (RFP), for the original services. We also require

⁷⁷ See <http://www.sl.universalservice.org/reference/ServiceSub.asp>.

⁷⁸ A "minor contract modification" is defined as "a change to a universal service contract that is within the scope of the original contract and has no effect or merely a negligible effect on price, quantity, quality, or delivery under the original contract." See 47 C.F.R. §54.500(g).

⁷⁹ *In the Matter of Request for Review of the Decision of the Universal Service Administrator by Copan Public Schools, Copan Oklahoma, Federal-State Joint Board on Universal Service, Changes to the Board of Directors of the National Exchange Carrier Association, Inc.*, CC Docket Nos. 96-45 and 97-21, 15 FCC Rcd 5498, 5502 para 7 (2000) (*Copan Order*).

⁸⁰ In other words, if an applicant requests support for an eligible service with a pre-discount price of \$100, the applicant may substitute a comparable eligible service with a pre-discount price of \$120, but will receive support based on the \$100 pre-discount price requested, rather than the \$120 pre-discount price ultimately received.

⁸¹ See, e.g., Funds for Learning NPRM Comments at 27; NYPL NPRM Comments at 7; Tel/Logic NPRM Comments at 15; see also *Task Force Recommendation* at 11.

⁸² We clarify that a service or equipment change request would not meet this test if it changes the type of service requested pursuant to the original funding request from one category to another (e.g., a change from telecommunications service to internal connections, or a change from Internet access to telecommunications service). We further clarify that a substitution that constitutes a minor contract modification under our rules will not automatically meet the requirements of our service substitution rule.

that support not be provided in excess of the amount the applicant originally would have been eligible for. By adopting these procedures as rules, we recognize that events may occur between the time of the original funding request and the time when commitments are made that make the original funding request impractical or even impossible to fulfill.

44. *Eligibility of On-Premises Equipment as Part of Priority One Service.* In the *Schools and Libraries NPRM*, the Commission sought comment on whether to modify its policies regarding the funding of Priority One services (telecommunications service and Internet access) that include service provider charges for capital investments for wide area networks. Those policies were established in the *1999 Tennessee Order* and the *Brooklyn Order*.⁸³

45. We decline at this time to modify our existing policies in this area, and in the attached Further Notice of Proposed Rulemaking seek more focused comment on specific rule changes that would limit the availability of discounts for service provider charges that recoup the cost of significant infrastructure investment. We do, however, clarify the scope of the existing requirements in this area to facilitate USAC's processing of applications.

46. In the *1999 Tennessee Order*, the Commission addressed the issue of whether certain facilities located on the applicant's premises (namely, routers and hubs) are part of an end-to-end Internet access service or part of internal connections.⁸⁴ The Commission determined that facilities located on an applicant's premises should be presumed to be internal connections, but that an applicant may rebut that presumption.⁸⁵ In analyzing the facts presented in the *1999 Tennessee Order*, the Commission concluded that this presumption had been rebutted. In support of the rebuttal, the Commission noted that the hub sites at issue constituted the Internet access provider's points of presence and that the applicant's internal connections networks would continue to function without the hub sites, indicating that the hub sites were not necessary to transport information within the schools' instructional buildings on a single campus.⁸⁶ Further, the Commission found that other indicia--the ownership of the facility, the lack of a lease-purchase arrangement, the lack of an exclusivity arrangement, and the fact that the service provider was responsible for its maintenance--supported its conclusion that, on balance, the facilities should be deemed part of an end-to-end service.⁸⁷ The Commission found that these

⁸³ *Request for Review by Brooklyn Public Library, Federal-State Joint Board on Universal Service, Changes to the Board of Directors of the National Exchange Carrier Association, Inc.*, File No. SLD-149423, CC Dockets No. 96-45 and 97-21, Order, 15 FCC Rcd 18598 (2000) (*Brooklyn Order*); *Request for Review by the Department of Education of the State of Tennessee of the Decision of the Universal Service Administrator, Request for Review by Integrated Systems and Internet Solutions, Inc., of the Decision of the Universal Service Administrator, Request for Review by Education Networks of America of the Decision of the Universal Service Administrator, Federal-State Joint Board on Universal Service, Changes to the Board of Directors of the National Exchange Carrier Association, Inc.*, CC Docket Nos. 96-45 and 97-21, Order, 14 FCC Rcd 13734 (1999) (*1999 Tennessee Order*).

⁸⁴ *1999 Tennessee Order*, 14 FCC Rcd 13734

⁸⁵ *Id.* at 13753-54 paras. 37-38

⁸⁶ *Id.* at 13753-54 para. 38.

⁸⁷ *Id.* at 13754-55 paras. 39-40

factors weighed against a finding of internal connections, even though the cost of leasing those facilities represented nearly 67 percent of the total funding request. The decision was based on the facts presented; the Commission did not establish a per se requirement that an applicant must meet all factors in order to receive discounts on service provider charges for the cost of leasing on-premises equipment.

47. We conclude it is administratively efficient for USAC to use the factors relied upon in the *1999 Tennessee Order* as a processing standard. USAC has posted an advisory on its website providing guidance to help applicants and service providers understand how it has implemented the *1999 Tennessee Order*.⁸⁸ Specifically, USAC has provided guidance that a private branch exchange (PBX) that routes calls within a school or library is not eligible for support as Priority One on-premises equipment. This guidance is consistent with our *1999 Tennessee Order* because a PBX, like most on-premises equipment, is presumed to be Priority Two internal connections. Moreover, it is unlikely that an applicant would be able to establish a rebuttal to that presumption, because the PBX functions to transmit information from and between multiple locations within a local network. If the PBX were removed from a school, the school would lose its ability to route phone calls within the building or campus, but could maintain its access to the public switched telephone network. In other words, the PBX is necessary to maintain the internal communications network, but not its end-to-end access to telecommunications services.⁸⁹

48. We now clarify that the *1999 Tennessee Order* does not preclude the provision of support for on-premises equipment that constitutes basic termination equipment. Accordingly, an applicant may receive a discount for the lease of a cable modem as part of Priority One Internet access. A cable modem is a type of basic terminating component. It is analogous to a channel service unit/data service unit (CSU/DSU) or a network interface device (NID) in that it functions as the termination point for a Priority One service.⁹⁰ The language in the *1999 Tennessee Order* stating that facilities located on the school premises are presumed to be internal connections was enunciated in the context of considering the status of network hubs and routers, and should not be read to encompass basic termination equipment. A basic terminating component, though normally located on a customer's premises, is necessary to receive the end-to-end Internet access service because it provides translation of the digital transmission using the appropriate protocols. In the case of a cable modem, it would not be possible to receive the Internet access service in question without the cable modem on the customer's premises. Conversely, the internal connections on the site would continue to function without the cable modem. Moreover, while customers may obtain cable modems from other sources, providers of cable modem service typically offer customers the opportunity to lease a cable modem in conjunction with the provision of cable modem service. We also note that the cost of leasing a cable modem is a relatively low proportion of the yearly cost of the service. The fact that technical limitations would, as a

⁸⁸ See <http://www.sl.universalservice.org/reference/OnPremPl.asp>.

⁸⁹ We note that an applicant will still be able to receive discounts for Centrex service, which telecommunications carriers provide without the use of on-premises equipment, as a Priority One service.

⁹⁰ USAC provides discounts on the cost of leasing a single CSU/DSU, as well as the cost of installing a NID, as part of a Priority One service.

practical matter, preclude the service provider from using the cable modem to deliver service to other customers, creating a de facto exclusivity arrangement, in our view does not support a finding that such equipment must be viewed as internal connections. Rather, we conclude that it is appropriate to provide discounts on the lease of a single basic terminating component used at a site as a Priority One service.⁹¹

49. We also clarify that it is appropriate to provide Priority One discounts on service provider charges to recoup the cost of leasing optical equipment to light fiber, when that optical equipment is the single basic terminating component of an end-to-end network and it is necessary to provide an end-to-end telecommunications or Internet access service. We reach that conclusion even though the optical equipment on the customers' end, as a technical matter, is dedicated to the customer's sole use.

C. Carryover of Funds

1. Background

50. In the *Schools and Libraries NPRM*, the Commission sought comment on whether to carry forward unused funding to subsequent funding years.⁹² Subsequently in the *Schools and Libraries Order*, the Commission concluded that, beginning with the second quarter of 2003, any unused funds from the schools and libraries support mechanism would, consistent with the public interest, be carried forward for disbursement in subsequent funding years of the schools and libraries support mechanism.⁹³

51. In the *Schools and Libraries Further Notice*, the Commission proposed specific rules and procedures for implementing the carrying over of unused funds to subsequent funding years of the schools and libraries mechanism.⁹⁴ In particular, the Commission proposed to amend the rules to require USAC to provide quarterly estimates to the Commission regarding the amount of unused funds that will be available to carry forward.⁹⁵ The Commission also proposed to amend the rules so that the Commission would carry forward available unused funds from prior years on

⁹¹ To the extent an applicant seeks to lease multiple terminating components, one would be deemed eligible for funding as a Priority One service and the remainder would be eligible for funding as Priority Two internal connections. Further, if an applicant seeks to purchase a single basic terminating component, it will be eligible for a discount only as Priority Two internal connections.

⁹² *Schools and Libraries NPRM*, 17 FCC Rcd at 1940-41 para. 70.

⁹³ See *Schools and Libraries Order*, 17 FCC Rcd at 11523-24 para. 3. In the *Schools and Libraries Order*, the Commission decided that it was in the public interest to take immediate action to stabilize the contribution factor while the Commission considered whether and how to reform the way in which contributions to the universal service mechanism were assessed. The Commission determined that unused funds would be applied to reduce the contribution factors for the third and fourth quarters of 2002 and the first quarter of 2003. Starting with the second quarter of 2003, any unused funds from the schools and libraries fund would be carried forward for disbursement in the schools and libraries support mechanism.

⁹⁴ *Schools and Libraries Further Notice*, 18 FCC Rcd at 9233-34 paras. 93-98.

⁹⁵ *Id.* at 9233 para. 94.

an annual basis for use in the following full year of the schools and libraries program.⁹⁶ Most comments on this issue supported the proposed rules and procedures. In its last quarterly filing, USAC reported \$420 million in unused funds.⁹⁷

2. Discussion

52. We adopt the procedures for carrying forward unused funds for the schools and libraries program proposed in the *Schools and Libraries Further Notice*. Specifically, we amend our rules to require the Administrator to provide quarterly estimates to the Commission regarding the amount of unused funds that will be available for carryover in the subsequent full funding year. We further amend our rules so that the Commission will carry forward available unused funds from prior years on an annual basis. We find that, in light of the high demand for discounts, such action is consistent with section 254 and the public interest, as well as the framework established in the *Schools and Libraries Order*. Accordingly, we amend section 54.507(a) of our rules, as provided in Appendix A.⁹⁸

53. The Administrator shall continue to estimate unused funds as the difference between the amount of funds collected, or made available for that particular funding year, and the amount of funds disbursed or to be disbursed.⁹⁹ We note that the Administrator already considers the remaining appeals for a funding year when identifying unused funds.¹⁰⁰ Therefore, we do not believe that the carryover of unused funds will detract from the funding of outstanding appeals.¹⁰¹

54. Consistent with the proposed rules in the *Schools and Libraries Further Notice*, we also amend the rules to require the Administrator to file with the Commission quarterly estimates of unused funds from prior years of the schools and libraries support mechanism when it submits its projection of schools and libraries program demand for the upcoming quarter.¹⁰² This amendment codifies the Administrator's existing reporting practice and reporting cycle.¹⁰³ The quarterly estimate serves to prepare the Administrator for the annual release of carryover funds and provides schools and libraries with general notice regarding the amount of unused funds that may be made available in the subsequent year.¹⁰⁴ We disagree with NAIS that the quarterly

⁹⁶ *Id.*

⁹⁷ See Federal Universal Service Support Mechanisms Fund Size Projections for the First Quarter 2004, available at <http://www.universalservice.org/overview/filings> (filed October 31, 2003) (*USAC Filing for First Quarter 2004 Projections*).

⁹⁸ See Appendix A

⁹⁹ See *Schools and Libraries Further Notice*, 18 FCC Rcd at 9234 para. 96

¹⁰⁰ See, e.g., *USAC Filing for First Quarter 2004 Projections* at 30-32.

¹⁰¹ See CoSN and ISTE FNPRM Comments at 3; EdLiNC FNPRM Comments at 1.

¹⁰² See 47 C.F.R. §54.709.

¹⁰³ See *Wireline Competition Bureau Announces No Change in Third Quarter 2002 Universal Service Contribution Factor*, CC Docket No. 96-45, Public Notice, 17 FCC Rcd 11128, 11129 (2002).

¹⁰⁴ See *Schools and Libraries Further Notice*, 18 FCC Rcd at 9233 para 94.

reporting procedure would become too cumbersome and hinder the “overall integrity of the program.”¹⁰⁵ We do not believe that the Administrator will be overburdened by this requirement because it has been reporting quarterly estimates of unused funds for six quarters without a problem.

55. We further amend the rules to make unused funds available annually in the second quarter of each calendar year for use in the next full funding year of the schools and libraries mechanism. Based on the estimates provided by the Administrator, the Commission will announce a specific amount of unused funds from prior funding years to be carried forward in accordance with the public interest to increase funds for the next full funding year in excess of the annual funding cap. For example, the Commission will carry forward the unused funds as of second quarter 2004 for use in the Schools and Libraries Funding Year 2004, thereby increasing the available funds in Funding Year 2004 above the annual funding cap of \$2.25 billion.¹⁰⁶ The Wireline Competition Bureau will announce the availability of carryover funds during the second quarter of the calendar year, when it announces the universal service contribution factor for the third quarter of each year.¹⁰⁷ The amount of unused funds to be carried forward will be deemed approved by the Commission if it takes no action within 14 days of release of the public notice announcing the contribution factor and the amount of unused funds.

56. We determine that it is in the public interest to carry forward unused funds for disbursement on an annual basis in the second quarter of the calendar year. Distribution of unused funds on an annual basis allows the Administrator to refine its calculation of available funds over four reporting quarters as the funding year progresses starting with the third quarter of the calendar year. The annual carryover of funds during the second quarter of the calendar year also coincides with the time of year the Administrator begins making funding commitment decisions for the upcoming funding year.¹⁰⁸ We believe that the timing of this process provides certainty regarding when unused funds will be carried forward for use in the schools and libraries program with minimal disruption to the administration of the program.¹⁰⁹

57. In order to implement the Commission’s prior decision to carry over funds beginning April 1, 2003, we modify the schedule for this year only in order to implement the process for Funding Year 2003. We direct the Administrator to carry forward unused funds as projected for the first quarter of 2004 for use during the remainder of Funding Year 2003.¹¹⁰ While there will

¹⁰⁵ See NAIS FNPRM Comments at 1

¹⁰⁶ Consistent with the *Schools and Libraries Order*, all unused funds as of second quarter of 2003, i.e., any remaining unused funds from all funding years, will be carried forward into Funding Year 2004 in accordance with the public interest. *Schools and Libraries Order*, 17 FCC Rcd at 11530-31 para. 19.

¹⁰⁷ 47 C.F.R. §54.709(a)(3)

¹⁰⁸ Applicants learn about their funding commitments via a Funding Commitment Decision Letter (FCDL). The Administrator releases FCDLs in waves every other week. For Funding Year 2003, the first wave of letters was released April 28, 2003.

¹⁰⁹ *Schools and Libraries Further Notice*, 18 FCC Rcd at 9234 para. 97

¹¹⁰ See *USAC Filing for First Quarter 2004 Projections* at 30-32.

be an increase in the amount of funds available in Funding Year 2003, we note that no decisions previously made by USAC concerning the distribution of funds for Funding Year 2003 will be reversed or revisited. Only funding requests that are currently pending will be considered for the Funding Year 2003 carryover funding. Henceforth, starting with the second quarter of 2004, funds will be carried over on an annual basis as described in the previous paragraph.

58. Finally, we take this opportunity to revise section 54.509(b) of the Commission's rules to conform to the *Fifth Order on Reconsideration*.¹¹¹ Section 54.509(b) provides that, if the estimates of future funding needs of schools and libraries lead to a prediction by the Administrator that total funding requests will exceed available funding for a funding year, the Administrator shall adjust the discount matrix by calculating a percentage reduction of support to all schools and libraries, except those in the two most disadvantaged categories, in order to permit all requests in the next funding year to be fully funded. The technical correction we make to section 54.509(b) clarifies that the reduction in percentage discounts explained in section 54.509(b) does not apply within a filing window or period, as described in section 54.507(c). Priority within a filing window is determined in accordance with section 54.507(g)(1) of the rules. Thus, section 54.509(b) applies only during a funding year in which the Administrator is acting in accordance with section 54.507(g)(2). We find that the rule change is exempt from the notice and comment requirements of the Administrative Procedure Act because it concerns a non-substantive technical change to the existing rules.¹¹²

IV. SECOND FURTHER NOTICE OF PROPOSED RULEMAKING

A. Discount Matrix

59. Under the Commission's rules, eligible schools and libraries may receive discounts ranging from 20 percent to 90 percent of the pre-discount price of eligible services, based on indicators of need.¹¹³ We seek comment on the effectiveness and efficiency of the discount matrix used to determine support payments for eligible applicants. In particular, we seek comment on changing the matrix to adjust the levels of discounts received by schools and libraries for supported services. We also particularly seek comment from the State members of the Federal-State Joint Board on Universal Service, and commit to ongoing informal consultations on these issues.

60. Interested parties have indicated that an altered discount matrix may better serve the schools and libraries program. In response to the *Schools and Libraries NPRM*, several commenters asserted that reducing the discount rate would make applicants more accountable for

¹¹¹ *Fifth Order on Reconsideration*, 13 FCC Rcd at 14936-40 para. 34-38.

¹¹² 5 U.S.C. § 553(b)(3)(A).

¹¹³ See 47 C.F.R. § 54.505. Schools and libraries in areas with higher percentages of students eligible for free or reduced-price lunch through the National School Lunch Program or a federally approved alternative mechanism qualify for higher discounts for eligible services than applicants with low levels of eligibility for such programs. Schools and libraries located in rural areas also generally receive greater discounts. *Id.*

their funding requests¹¹⁴ and dissuade vendors from improperly offering to forgive or refund the 10 percent contribution required of applicants in the highest discount band.¹¹⁵ In addition, commenters stated that altering the discount rate would be an effective way to increase the availability of funds for eligible applicants outside the highest discount band.¹¹⁶ While the *Universal Service Order* prioritized support for entities with the greatest level of economic disadvantage,¹¹⁷ some interested parties have suggested that greater emphasis should be given to the equitable distribution of E-rate funds to eligible applicants from all discount bands, to ensure that they have comparable access to advanced telecommunications and information services.¹¹⁸ Participants in the Commission's Public Forum on the E-rate program in May 2003 also suggested that the Commission amend its discount matrix, and USAC's Task Force on Waste, Fraud, and Abuse has recommended that the discount level for internal connections be lowered from 90 percent to 80 percent.¹¹⁹

61. For these reasons, we seek comment on whether the Commission should amend the discount matrix to reduce the discounts available in some or all of the discount bands, including the current 90 percent discount band. We propose that such a change, if adopted, become effective in Funding Year 2005. We seek comment on whether the current discount matrix provides sufficient incentives for schools and libraries to limit funding requests to services that can be efficiently used and for vendors to competitively price their services. We also seek comment on whether it would be appropriate to adjust the discount matrix in order to expand the reach of funding to lower discount bands. We note that the rules we adopt in the *foregoing Order*,

¹¹⁴ See, e.g., Iowa DOE NPRM Comments at 3-4; Pennsylvania Board of Education NPRM Comments at 7. Some interested parties have claimed that the minimal financial contribution required of applicants in the highest discount band allows applicants to request funds without regard to need or cost-effectiveness and allows vendors to exploit the system. See, e.g., Iowa DOE NPRM Comments at 3-4; Pennsylvania Board of Education NPRM Comments at 7. Some parties assert that 90 percent applicants periodically request funding for services and equipment that they cannot practically utilize. Letter from Greg Weisiger, Virginia Department of Education, on behalf of CCSSO (filed Mar. 18, 2003).

¹¹⁵ See, e.g., Funds for Learning, LLC NPRM Comments at 15; Tel/Logic NPRM Comments at 18 & n.5. Specifically, some commenters suggested that vendors offer "grants" or extra services, in the amount equivalent to the applicants' contribution to those applicants that must pay 10 percent of the costs as consideration for accepting a vendor's bid. See, e.g., Iowa DOE NPRM Comments at 3-4; Pennsylvania Board of Education NPRM Comments at 7, see also Letter from Greg Weisiger, Virginia Department of Education, on behalf of CCSSO (filed Mar. 18, 2003) and Semiannual Reports of the Office of the Inspector General.

¹¹⁶ See e.g., Illinois State Board of Education NPRM Comments at 10; Pennsylvania Department of Education NPRM Comments at 7; Council of Chief State School Officers NPRM Comments at 47-48. Several parties reiterated these suggestions at a May 8, 2003, public forum held by the Commission. See *E-rate Public Forum*, BellSouth Statement at 10; Funds for Learning, LLC Statement at 12, and American Library Association Statement at 4-5.

¹¹⁷ See *Universal Service Order*, 12 FCC Rcd. at 9038 paras. 497-499.

¹¹⁸ See, e.g., Illinois State Board of Education NPRM Comments at 10; Pennsylvania Department of Education NPRM Comments at 7; CCSSO NPRM Comments at 47-48; *E-Rate Public Forum*, BellSouth Statement at 10-11.

¹¹⁹ See, e.g., *E-Rate Public Forum*, Funds for Learning Statement at 13 (matrix should be revised so that all schools with 50 percent or more students eligible for free lunch receive equal discounts) and StateNets Statement at 3, *Task Force Recommendation* at 3-4.